

UNITED STATES OF AMERICA  
POSTAL REGULATORY COMMISSION  
WASHINGTON, DC 20268-0001

Statutory Review of the System  
for Regulating Rates and Classes  
for Market Dominant Products

Docket No. RM2017-3

COMMENTS OF  
THE AMERICAN CATALOG MAILERS ASSOCIATION, INC. (ACMA) AND  
THE PARCEL SHIPPERS ASSOCIATION (PSA)  
(March 1, 2018)

The American Catalog Mailers Association and The Parcel Shippers Association respectfully submit these comments pursuant to Order No. 4258.<sup>1</sup>

INTRODUCTION AND SUMMARY

These comments address: (I) our support for a price cap system; (II) the supplemental surcharge (“MM Surcharge” or “MMS” ) proposed for Marketing Mail Flats (MM Flats) and Marketing Mail Parcels (MMP); (III) the proposed performance incentive; and (IV) the importance of the Commission explaining how it would accommodate changes in postal law made by Congress.

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<sup>1</sup> Notice of Proposed Rulemaking for the System of Regulating Rates and Classes for Market Dominant Products, December 1, 2017 (Order No. 4258).

We begin by restating our support for a continuation of a basic price cap system, consistent with our earlier comments in this proceeding.<sup>2</sup>

Next, we explain why the proposed MMS for MM Flats and MMP is neither required nor appropriate, and may unnecessarily harm, rather than help, the financial position of the Postal Service. On this matter, we conclude that it is the operator, not the regulator, who should make associated pricing decisions.

In prior dockets, ACMA and others have challenged whether Marketing Mail Flats and other flats products should be considered “under water,” pointing to exorbitant cost increases and problematic costing outcomes. In these comments we show that even if the reported costs are accepted, the proposed MMS should not be imposed. To do this we: (A) review the law to establish that surcharges are not required, (B) explain that the imposition of the MMS requirement will not likely produce additional net revenue for the Postal Service; at best it will simply increase rates for MM Flats and MM Parcels and bring about a small reduction in other rates in the Marketing Mail Class, (C) demonstrate that focusing on the cost coverage of MM Flats alone is not inherently meaningful and that a better approach is to look at the cost coverage for all flats in the Marketing Mail Class, including Carrier Route and High Density, (D) show that, as maintained by the Postal Service in this and past dockets, imposing the MMS

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<sup>2</sup> See Comments of the Data & Marketing Association, American Catalog Mailers Association, American Forest & Paper Association, Association for Postal Commerce, Envelope Manufacturers Association, Greeting Card Association, Idealliance, Parcel Shippers Association, and Saturation Mailers Coalition, Pursuant to Commission Order No. 3673, March 20, 2017 (“DMA *et al.* Comments”).

requirement may result in a reduction in contribution for the Marketing Mail Class and the Postal Service, (E) summarize reasons explained in past dockets that demonstrate uncertainty about costs attributed to flats, and (F) explain that the Commission's proposal for MM Flats and Parcels surcharges does not give sufficient weight to the importance of pricing flexibility for the operator.

I. THE COMMISSION SHOULD CONTINUE THE EXISTING PRICE CAP SYSTEM FOR MARKET DOMINANT PRODUCTS.

In an earlier stage of this proceeding we joined other parties to urge the Commission to retain the existing price cap system for market-dominant rates and classifications:

In conclusion, the rate setting procedure Congress established in 2006 has worked, is working and will work. This procedure is far, far superior to the cost of service administrative procedure of the 1970 Act. We urge the Commission to continue unchanged the PAEA rate setting process and procedures.

DMA et al. Comments at 4. In those comments we pointed out:

USPS finances indicate that rates provide USPS with adequate revenues to meet controllable and operating costs. They provide funds for operations (personnel, capital, facilities, etc.), payment for workers' compensation insurance to the Department of Labor, and payments for the annual cost of retiree health benefits. USPS is in the enviable financial position of having over 90% funding for its defined benefit

pension plans. Even for retiree health benefits, USPS has 50% funding and has not dipped into those funds in the 10 years since the passage of PAEA.

*Id.* at 3.<sup>3</sup> Therefore, we are pleased with the Commission's proposal to retain principal aspects of the existing price cap system.

II. THE MMS PROPOSAL FOR MM FLATS IS NOT REQUIRED, MAY UNNECESSARILY HARM, RATHER THAN HELP, THE FINANCIAL POSITION OF THE POSTAL SERVICE, AND UNNECESSARILY INTRUDES ON MANAGEMENT'S PRICING FLEXIBILITY.

A. The MMS proposal for MM Flats Is not required.

It is generally accepted, and the Commission agrees, that section 3622(c)(2),<sup>4</sup> although it is the principal factor relating to cost coverages, does not itself require that categories designated as "products" cover their attributable costs. In Docket No. ACR2010, the finding that the cost coverage of Standard Flats (now MM Flats) was too low to be in compliance was based on general "Policy Guidance" in section 101(d) that "Postal rates shall be established to apportion the costs of all postal operations to all users of the mail on a fair and equitable basis." The Postal Service appealed this finding.<sup>5</sup> The court classified 101(d) as a "failsafe protection" and found "that § 3622(c)

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<sup>3</sup> Note footnote 2 ("USPS is constrained to have the billions and billions of dollars in its pension and retiree health benefits funds invested in low yield government instruments. If it could invest those funds in a more balanced portfolio, the funding percentages would be significantly higher. Only Congress has authority to correct this. It is not the fault of the PAEA ratemaking process.").

<sup>4</sup> Unless otherwise noted, section citations are to title 39, United States Code.

<sup>5</sup> *United States Postal Service v. Postal Regulatory Commission*, 676 F.3d 1105 (D.C. Cir. 2012) ("*USPS V. PRC*").

permits the Commission to invoke § 101(d) vis-à-vis market-dominant products, at least in extreme circumstances.”<sup>6</sup> It remanded the case to the Commission “for a definition of the circumstances that trigger § 101(d)’s failsafe protection, and for an explanation of why the particular remedy imposed here is appropriate to ameliorate that extremity.”<sup>7</sup>

The Commission considered the circumstances that trigger section 101(d) and the remedy imposed in its 2010 ACD. It explained in Order No. 1427 that the “totality of circumstances presented” (at 4) must be considered and went on to explain its remedy. It is clear that the Commission must exercise some discretion in this matter, and that the law allows it to do so. In sections B through F below, we explain that the circumstances have changed, including that certain matters are better understood now, and that the Postal Service should be given the flexibility to deal with associated pricing matters. Considering things now, extra rate increases for MM Flats and MM Parcels are not warranted.

- B. Imposition of MMS for MM Flats or MM Parcels will not likely produce additional revenue for the financially challenged Postal Service.

In Order No. 4258, the Commission summarizes a focus on finances:

The existing ratemaking system did not achieve the PAEA’s objectives during the 10 years following the PAEA’s enactment. *See generally* Order No. 4257. The Postal Service is in poor financial health. *Id.* at 274. The market dominant ratemaking system established under 39 U.S.C. 3622 did not assure “adequate revenues, including retained earnings, to

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<sup>6</sup> *USPS V. PRC* at 1108.

<sup>7</sup> *USPS V. PRC* at 1109.

maintain financial stability,” as required by Objective 5. *Id.* at 178 (quoting 39 U.S.C. 3622(b(5))).

Order No. 4258 at 27.

Under the existing system, “[i]f a non-compensatory product forms part of a class that is compensatory on the whole, then the rates for the non-compensatory product *can be increased by a greater percentage* than the compensatory products in that class while keeping the overall class increase within the price cap.” Order No. 4258 at 81-82 (emphasis added). The Commission’s proposal changes this option to a requirement, and specifies that the rate increase for the non-compensatory product ***must be at least 2 percentage points higher*** than the increase for the class (proposed Rule 3010.201). Unlike the proposal for non-compensatory classes, the extra 2 percentage points, or more, is offset by lower increases for one or more of the other products in the class.<sup>8</sup> While this may benefit the other products as a group, the benefit is unlikely to be significant.<sup>9</sup> And, as explained further below, this mandated surcharge may not result in additional contribution. In short, the extra 2 percentage points is not a material element in a fix for Postal finances.

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<sup>8</sup> Order No. 4258 at 121 (“Section 3010.201 Individual product requirement. For non-compensatory products, the Postal Service shall increase the rate of the product by a minimum of 2 percentage points above the percentage increase of the class that includes the non-compensatory product. Rates for the compensatory products in the class shall be adjusted accordingly. This section does not create additional rate adjustment authority for the class.”).

<sup>9</sup> See *infra* at 9 (“In 2017, a 2 percentage point increase in the rate for MM Flats would allow a decrease in the rate for a 28-cent letter of 0.072 cents, which might round to a tenth of a cent. This effect will be smaller in 2018 and future years.”).

- C. Focusing on the cost coverage of MM Flats is not particularly meaningful; a better approach is to focus on the cost coverage for all flats in the Marketing Mail Class, including Carrier Route and High Density.

ACMA has explained that MM Flats is a part of a suite of flats offerings, but that it has devolved into a residual category.<sup>10</sup> The relationship among these categories is one of interdependency. Specifically, mailers computer-prepare mail to use High Density and Carrier Route when possible, and the residual is sent in MM Flats. In FY 2017, the volume of MM Flats was only 6.3 percent of MM mail. This proportion will be lower in 2018, due to shifting out of FSS categories. Also, MM Flats is in secular decline. Under these conditions, assessments of cost coverage are most meaningful at the level of combined categories, not MM Flats by itself.

The Postal Service recently acknowledged ACMA's analysis:

ACMA discusses the similarities between the three flats-mailing options in Marketing Mail. For instance, ACMA notes that the High-Density Flats rate category has received volume from both the USPS Marketing Mail Flats product and Carrier Route Flats rate category within the Carrier Route product, due to co-mailing and other factors. Indeed, Carrier Route Flats and High-Density Flats appear to contain more finely presorted mail from many of the same mailers who use the less finely presorted rates in the USPS Marketing Mail Flats product. In addition, Flats, High-Density Flats, and Carrier Route Flats are frequently prepared together in the same containers and, in Flats Sequencing System (FSS) zones, the same bundles. The Postal Service also confirms the accuracy of ACMA's calculation in Table 1 of its comments, showing that if commercial USPS Marketing Mail Flats and commercial Carrier Route Flats had been combined in FY 2017, cost coverage would have exceeded 100 percent for this commercial-only product. The Postal

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<sup>10</sup> See Initial Comments of the American Catalog Mailers Association (ACMA), Docket No. ACR2016 ("ACMA ACR 2016 Comments"); Initial Comments of the American Catalog Mailers Association (ACMA), Docket No. ACR 2017 ("ACMA ACR 2017 Comments").

Service will consider ACMA's points, to the extent they are applicable, in future pricing and classification cases.

Reply Comments of the United States Postal Service, Docket No. ACR2017, February 12, 2018, at 5 (footnotes omitted).

So, as part of the suite, MM Flats must be there, though its role is ebbing. As well, it serves local and low-density mailers who cannot qualify for Carrier Route. In Marketing Mail, Standard Mail, and third-class mail, mailers in low-density categories have always been watched out for.<sup>11</sup> One reason for this is the role they play in their communities, including activities of nonprofit organizations that many view as critical,<sup>12</sup> and another is that some of them will grow into larger mailers.<sup>13</sup> And given that the volume of MM Flats is so low, it is easy to err on the side of caution. MM Flats is small enough that an increase in its rate, under a cap, would allow only a small decrease in the rates for other MM mailers. In 2017, a 2 percentage point increase in the rate for MM Flats would allow a decrease in the rate for a 28-cent letter of 0.072 cents, which might round to a tenth of a cent. This effect will be smaller in 2018 and future years.

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<sup>11</sup> An element in the practice of watching out for small mailers has been and is the requirement that mailers with sufficient density to prepare 5-digit presort must do that preparation, even if they find it most profitable to presort in lesser degree. The theory is that greater presortation when possible, not when feasible, will lower costs and make rates lower for all concerned. Using Carrier Route and High Density is in all cases optional.

<sup>12</sup> In Docket No. RM2017-12, which concerned aspects of how Nonprofit rates are set, over 100 nonprofit organizations submitted comments. It seemed apparent that the work they are doing should be appreciated by everyone.

<sup>13</sup> Although most of our members are large mailers, and are interested in the rates they pay, they are not insensitive to the interests of smaller mailers. It is not uncommon to hear the position: "We were small mailers once. We do not want to see them targeted with undue rate increases."

Still at the level of the overall Postal Service, there is one other consideration that should be kept in mind and that argues for allowing flexibility in managing the rates for MM Flats. The Postal Service has a principal assignment of maintaining a viable, universal delivery system, with high service standards. This means it must have a nationwide processing, distribution, and transportation system, that feeds into its delivery system. It should be clear without proof that if this system does not have volume, it will have no scale economies, its costs will be exceedingly high, its service may suffer, there will be arguments to increase the rates even more, and the arguments (indeed the need) to allow private delivery will be stronger.<sup>14</sup>

We stated above that much of the volume of MM Flats is outside the largest cities, often in smaller towns and lower-density areas. This includes rural areas and lower-income areas in both small and large cities. Due to rates for MM Flats that are already high,<sup>15</sup> we believe that many mailers are on the verge of branding mail to these areas as unprofitable. Further rate increases would hasten this process. This would begin removing mail from the processing and transportation system, helping to bring about the high-cost state described above. Another possibility is that more of this mail would find a way to achieve Carrier Route status. But if only Carrier Route and High

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<sup>14</sup> There exists a serious question whether the rates of flats in MM Mail are at or above the stand-alone cost level, at least for an overwhelming number of addresses in the United States. If they are, alternative delivery could be successful. See Initial Comments of ACMA, Docket No. ACR2015, Feb. 2, 2016, at 5-8.

<sup>15</sup> In addition to being high in an absolute sense, MM Flats has seen large rate increases. Since FY 2006, the rates for MM Flats have increased 50.1 percent. Over the same period, the CPI increased only 21 percent.

Density mail remain, very little mail will need to be given outgoing processing and transportation. In FY 2017, 92.1 percent of Commercial Carrier Route was entered in the DSCF or the DDU, and another 6.1 percent was entered in a destination NDC. The destination proportions for High Density and Saturation were even higher. It seems apparent that accelerated increases in the rates of MM Flats would speed up this process, leaving some addresses with little mail and the Postal Service with a high-cost system.

- D. As maintained by the Postal Service in this and past dockets, imposing MMS increases on MM Flats will likely result in a reduction in revenue and contribution for the Marketing Mail Class and the Postal Service.

As the PRA<sup>16</sup> was implemented, rates were set to recognize cost levels and cost relationships during the period in which the rates would be in effect. This led to detailed projections of what were termed “test years,” usually two or three years beyond the most recent year for which data were available. This is not specifically done under the PAEA,<sup>17</sup> but neither the logic nor the efficiency of it has gone away. In fact, when the Postal Service proposes rates for implementation at a certain time, it would be derelict if it did not consider the future. And it needs to consider more than the next year or two.

In line with considering the future, the Postal Service has stated a consideration that can be boiled down to a few words: don’t waste your cap on a product whose

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<sup>16</sup> Postal Reorganization Act, Public Law 91-375, August 12, 1970.

<sup>17</sup> The Postal Accountability and Enhancement Act (PAEA), Pub L. 109-435, 120 Stat. 3198 (2006).

volume is disappearing. The Commission notes the Service's discussion of this admonition, and then a few pages later presents a table of the cost coverage for MM Flats under the extra 2 percentage points per year it has proposed. Table III-3, Order No. 4258 at 76 and 79. The table assumes CPI increases of 2.05 percent per year and unit cost increases of 2.6 percent per year. The table shows that as the rates of MM Flats increase, its cost coverage increases. The table does not show volume changes or contribution changes.

We believe that another step can be taken that includes consideration of the Service's don't-waste-your-cap rule. The essence of the rule is: (a) when the rates for MM Flats are increased, some other rates must be decreased, consistent with the cap; we did this calculation, and (b) the volumes of MM Flats are in autonomous decline while the volumes of some other products are increasing or constant. We assumed MM Flats volume to be declining 4.86 percent per year, equal to the average for the last 8 years. We assumed the other products are increasing at 4 percent per year.

We took the volume of MM Flats to be 1,000 in a base year. We grouped the other products together into one product. We began its volume at 6,000, thus six times as large as MM Flats. To deal with rate-induced volume losses, we assumed an elasticity of -0.4, a reasonably conservative figure.<sup>18</sup> We also extended the

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<sup>18</sup> In this exercise, we apply this elasticity to both MM Flats and to the other MM products as a group. It covers, then, a range of products. The Postal Service is not precluded from using different elasticities for each category. In general, based on specific information from a number of catalog firms, we believe the elasticity of catalogs is substantially higher (in absolute value) than -0.4.

Commission's table to 10 years. The years beyond 5 are at the CPI cap. The starting unit costs and unit revenues are those of the 2017 CRA, for MM Flats and the MM Class.

The details are shown in our spreadsheet, ACMA-PSA-RM2017-3.xlsx. The sheet allows other scenarios to be considered easily. Table 1 shows the results. These results may be compared to the Commission's Table III-3, center column, which assumes an extra 2 percent for MM Flats. Table 1 begins at a coverage of 73.8 percent, approximately equal to the coverage in the 2017 CRA. At the end of five years, it is up to 87.1 percent, an increase of 13.3 points. Table III-3 of the Commission shows an increase from 77.3 percent to 91.2 percent, an increase of 13.9 percentage points, but on a higher base. The Commission's increase is thus larger than ours, but not substantially. The contribution of MM Flats in Table 1, base through year 5, goes from -136 to -53. Its volume declines 31 percent, and this does not consider cross-elasticities, which we know to exist.<sup>19</sup>

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<sup>19</sup> Co-mailing, for example, is quite sensitive to rate differences. Also, mailers' joint use of MM Flats, Carrier Route, and maybe High Density in a single mailing event creates an interdependence among these categories.

Table 1	Volume, Cost Coverage, and Contribution for MM						
	Volume	Cov	Cont		Vol	Cov	Cont
	CPI + 2%				CPI + 4%		
Years	MM Flats						
0	1,000	73.8%	-136		1,000	73.8%	-136
1	936	74.9%	-125		929	76.3%	-117
5	720	79.2%	-88		693	87.1%	-53
10	539	77.1%	-83		519	84.8%	-53
	CPI				CPI		
Years	MM Class						
0	6,000	119.3%	234		6,000	119.3%	234
1	6,054	122.7%	279		6,062	122.8%	280
5	6,339	136.8%	483		6,380	136.8%	482
10	7,103	140.5%	625		7,163	139.3%	607
1-5	30,915	129.8%	1,892		31,070	130.0%	1,896
6-10	33,908	139.2%	2,830		34,169	138.5%	2,774

But when we examine the overall MM Class, we get a different picture. The contribution of the class begins at 234. At the end of year 5, it is 482 with an extra 2 percent for MM Flats and is 483 for CPI + 2% for all categories. At the end of year 10, the extra 2 percent gives a contribution of 607 and CPI + 2% for all categories gives 625. In this scenario, the Postal Service is not made better off financially by increasing the rates for MM Flats by an extra 2 percentage points.

We agree that other scenarios could be generated. The point is not that one scenario is a slam dunk over another. Rather, the point is that it is a close call whether the Postal Service is made better off financially by giving an extra rate increase to MM Flats. The same concern applies to the surcharge for MM Parcels. If this docket is to solve a financial problem for the Postal Service, matters relating to the cost coverage of MM Flats and MM Parcels do not belong in it.

- E. Reasons explained in past dockets cast doubt on the accuracy of the costs attributed to flats, thus making the costs and cost coverages unreliable for purposes of imposing the MMS increase.

Generally, the Commission has taken seriously its responsibility to analyze and question costing methods, and to specify the method to be used. In the case of flats costs, however, serious questions exist about the meaningfulness of the results being obtained and in the success of the Postal Service in controlling those costs.

The costs of MM Flats, and of flats mail generally, have increased exorbitantly and without acceptable explanation.<sup>20</sup> This is the primary reason, we believe, that the Commission has inquired extensively into these costs since its 2015 ACD and why, recently, it began Docket No. RM2018-1 to take more steps. Specifically, ACMA showed that since 1998 the unit costs for MM Flats, holding product mix constant, have increased 163.5 percent, far more than factor prices or the CPI, and this despite considerable evidence that the Postal Service is making technological improvements, often referred to as strategic initiatives, and mailers are improving mail preparation. Under these conditions, we believe it is reasonable to say that little in the way of confidence can be had in these costs.

If the rates of MM Flats were to be increased, the volume of MM Flats would decrease beyond the trends that exist. Relative to the overall volume of flats, these additional declines would be relatively small. Accordingly, the costs needed to evaluate these declines should be volume-variable costs that are suitable for relatively small volume changes. Attributable costs, to the extent different, are not relevant. And they would have to be costs that would actually change. Questions exist about whether the costs available are suitable, and these questions go beyond the rapid-increase questions raised above. First, the Postal Service has presented considerable empirical

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<sup>20</sup> See ACMA ACR 2016 Comments; ACMA ACR 2017 Comments. Note that the increases have occurred for Periodicals as well as MM Mail. Note also that the mail processing costs of Carrier Route and High Density are much lower than for MM Flats, so that increased delivery costs have been relatively more important to them.

evidence that the costs might not be as variable with volume as assumed in current costing. Second, ACMA has raised questions about the reasonableness of the city-carrier street costs.<sup>21</sup> Third, the Commission has agreed that the CRA-derived costs are probably “overinclusive” and thus do not represent actual effects.<sup>22</sup> And fourth, the mail processing costs alone for 5-digit automation flats, which make up 67.6 percent of Commercial, automation, non-FSS flats, is 16.4 cents more than the mail processing costs for Carrier Route.<sup>23</sup> Approximately, this should be the cost of one sort on an AFSM.<sup>24</sup> It is difficult to believe that 16.4 cents, plus other associated costs, would be saved if a 5-digit automation piece left the system.

- F. The Commission proposal for MM Flats and Parcels does not give sufficient weight to the importance of pricing flexibility for the Postal Service. The pricing of these products should be left to the operator.

While the Postal Service sets the rates for market-dominant products under the PAEA, the Commission has a significant role in assuring compliance with applicable law. Thus, it is the Commission that ensures that the price cap is correctly computed and applied. See section 3622(d). It is the Commission that approves or otherwise

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<sup>21</sup> ACMA ACR 2017 Comments at 12-15.

<sup>22</sup> PRC Op. MC95-1 (Jan. 26, 1996) at para. 4220.

<sup>23</sup> Docket No ACR2017, USPS Folders 11 and 18.

<sup>24</sup> To provide some perspective on the magnitude of a cost of 16.4 cents, it may be noted that the total cost of a Presorted First-Class letter is 12.0 cents and the average total cost of all MM mail is only 13.9 cents. These costs include acceptance, processing, transportation (by air in the case of First-Class), and delivery. The point is that a functioning postal system can do a lot for 16.4 cents.

specifies the methods used to measure and attribute costs. See section 3652(a)(1). It is the Commission that enforces the constraints on workshare discounts. See section 3622(e). And generally, it is the Commission's responsibility to "define a spectrum of lawful rates."<sup>25</sup>

Somewhat in competition with this oversight responsibility, is a key objective of the PAEA, "[t]o allow the Postal Service pricing flexibility." Section 3622(b)(4).<sup>26</sup> In a prior docket, "the Postal Service explains that the reason it did not give [MM] Flats an above-average price cap increase is that it believes such an increase would impair its ability to enhance its revenue/contribution under the price cap. In the Postal Service's view, this decision reflects an appropriate balance between the need to improve the cost coverage for [MM] Flats pursuant to the Commission's order, and the need for the Postal Service to increase contribution in order to remain economical."<sup>27</sup>

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<sup>25</sup> Order on Price Adjustments for Market Dominant Products and Related Mail Classification Changes, November 16, 2012 (Order No. 1541) (Taub dissenting in part at 3).

<sup>26</sup> See *id.* at 4 ("In contrast, in the revised statute, the authority to establish reasonable and equitable classes of mail and rates of postage is vested primarily in the Postal Service. The legislative history and structure of the act support this revised view. While the contours of a modern system of regulation must be determined by the Commission, it would be inappropriate for the Commission to assume its former role of selecting from among a spectrum of lawful rates and classifications the set of rates which is, in its judgment, most consistent with statutory criteria. In its new role of regulator rather than ratemaker, the function of the Commission is to define the spectrum of lawful rates. Within this spectrum, the Postal Service is responsible for selecting the set of rates which, in its judgment, is most consistent with its statutory mission.").

<sup>27</sup> Order on Standard Mail Rate Adjustments and Related Mail Classification Changes, December 11, 2012 (Order No. 1573) (Taub concurring at 3).

In the instant proposal to impose an extra 2% per year surcharge on MM Flats and Parcels, the Commission ventures into an area best left to the discretion of the Postal Service.

III. DESPITE OUR INHERENT INTEREST IN THE PERFORMANCE OF THE POSTAL SERVICE, SIGNIFICANT DIFFICULTIES ARE ASSOCIATED WITH THE COMMISSION'S "PERFORMANCE INCENTIVE MECHANISM." UNTIL THESE ARE RESOLVED, THE MECHANISM SHOULD NOT BE INCLUDED AS A COMPONENT IN A NEW REGULATORY SYSTEM.

As part of its proposal, the Commission has included a Performance Incentive Mechanism. Potentially, if a specified outcome is achieved, this mechanism allows one extra percentage point of rate authority. This is added onto any other elements of rate authority available.<sup>28</sup>

Specifically, the performance incentive comes in two parts: (a) an extra 0.25 percentage points of authority would be made available to a mail class if no elements of the service *standard* for that class are decreased during a Fiscal Year and (b) an extra 0.75 percentage points of authority would be made available to each mail class if a specified increase of 0.606 percent is achieved in a Fiscal Year in the 5-year running average of percentage increases in the TFP measure, as made available each year by

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<sup>28</sup> Note that this add-on to authority is additive, not compounded. For example, suppose authority of 4.05 percent were available (maybe 2.05 percent from the CPI and 2 percent special authority). If an extra 1 percent were achieved from the performance mechanism, the rate authority would be 5.05 percent. It is not the case that the rates resulting from the 4.05 percent would be multiplied by 1.01. We support this way of arranging authority. However, we would also note that the 5.05 percent would compound on the rates of the previous year, thus boosting rates upward more than might be thought.

the Postal Service. In the case of the latter, 5 annual TFP percentage increases for 5 years ending in the current year of 0.4 percent, 0.7 percent, 0.9 percent, 0.2 percent, and 0.8 percent would yield a 5-year average increase of 0.6 percent.

We deal with these two parts separately, in the following two sections.

- A. The service incentive of 0.25 percentage points is achieved by a decision on standards, unrelated to performance. It is not likely to be effective.

For purposes here, all aspects of service are boiled down and limited to whether specified proportions of the mail entered under certain conditions are delivered within a specified number of days. For each condition, the proportion and the number of days is published as the “standard.” Most of the standards are the same nationwide, although good reasons could exist for doing something different. The 0.25 percentage points of authority is granted to a class if none of the *standards* for that class are reduced in a Fiscal Year relative to the previous Fiscal Year. That is, the mechanism focuses on whether the standard is changed, not on whether the standard is achieved or on the degree to which the standard is achieved.

The 0.25 percentage points are granted on the basis of a *decision* not to reduce any standards. The Postal Service can clearly make this decision, making receipt of the authority automatic, a freebie. But it might not be a good idea to give the Postal Service an incentive to make this decision, and it might not be as free as it seems.

Particularly in recent years, with volume declines and pressures to meet a budget despite these declines, the Postal Service has needed to make consequential changes to its operations, and many people argue that it should have gone further. One of the

things that can be changed is service standards. If it is precluded from making such changes, because it would lose rate authority, it might decide against changes that could increase its overall effectiveness. That is, the Postal Service might decide that the price of making an improvement is too high. This should not be thought of as good. As mailers, we want an effective Postal Service; a constraint on changing standards, even on reducing them, could impede that.

Another perspective on the problem here can be obtained by asking whether the Postal Service has an incentive to *increase* its service standards. We would hope that it would consider increases, just to have happy customers and more volume, but we would not want to preclude consideration of service standard changes that might have rate implications. And conversely, if a reduction in standards were shown to allow a significant cost reduction, we might be willing to entertain a reduction.<sup>29</sup> Again, the mechanism proposed seems pretty one-sided.

We note as well that this mechanism runs counter to concerns that inherently arise when price caps are applied to firms. Regulators often worry that a firm, under a cap, might increase its profits by reducing its service levels. In response to this concern, it is common to *reduce* the cap authority when service declines. Though the proposed mechanism focuses on the standard instead of the level, it gives an *increase* in authority. Therefore, it appears to be going in the wrong direction.

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<sup>29</sup> We address here only service standards. These comments take no position on delivery frequency.

There is one more problem with the service mechanism, not obvious at first. If an increase in authority of 0.25 percentage points is achieved, it appears the rate base could be increased 0.25 percentage points and left there forever. In other words, a mailer must pay higher rates forever for a decision not to reduce standards in one year. This is an unbounded return on a decision. An arrangement of this kind should be avoided.

For these reasons, the service mechanism should not be implemented. It focuses on the wrong thing, may prevent meritorious changes, and goes in the wrong direction.

- B. The Efficiency Incentive of 0.75 percentage points is not aligned with the kind of performance that should be expected from the Postal Service and may penalize mailers for its success.

The Postal Service should be expected to make changes regularly. Many of these would involve investments that should have an ROI. Indeed a considerable amount of depreciation should be available each year, and reinvestment of this may be in order. If changes are well thought out and managed, and if investments meet the same test, reductions in cost (and sometimes increases in volume) should be expected. The depreciation on any investments could be used to repay the principal or reinvested. All this should lead to lower costs and increased profit. At the same time, in a rough sort of way, the overall productivity as measured by the TFP should increase.

But if the Postal Service performs in this way, as we believe it should, it would receive, at the beginning of a calendar year following the ACD of the year analyzed, for

use in a rate change initiated sometime that year, probably to be implemented the next year, a 0.75 percentage point increase in its rate authority. The question that arises is: why is rate authority needed two years or so after the investments are made, the operations are tightened, and the profits are realized? And a similar question is: why should mailers be penalized with higher rates in response to Postal Service success in managing its operations? If such success is evidence that the price cap is working, why should the cap then be relaxed? The relationships are backwards.

And even if all this made sense, it is doubtful that the TFP measure is up to the task of representing any progress that occurs. The Public Representative and Laurits Christensen (sponsored by the Postal Service) are on record in this case raising concerns about the TFP measure and explaining its long-term character. The Commission reviews the concerns in Order No. 4258 at 59-60.

Any doubt about the TFP's long term character was erased when the figure for FY 2017 was submitted to the Commission in response to CHIR No. 2, Question 4, January 17, 2018. The report shows that the TFP *declined* 0.561 percent in 2017. This provides a 5-year average increase of 0.307 percent, substantially below the 0.606 percent figure the Commission saw when it released its order. And since the TFP declined 0.2 percent in 2016 and increased only 0.1 percent in 2015 and 0.3 percent in 2014, all three of which will be elements in the 5-year average for 2018, it appears that it could be six years before the measure is anywhere near the 0.606 percent the Commission proposes as a threshold.

These outcomes suggest that five years for an average may be way too short to be meaningful. In its Annual Report for FY 2017, the Postal Service notes the reduction in 2017 and refers to the increase since 2009 (at 26). If the Commission's average were taken over a period this long, it would set up a long-term dynamic that has little relation to operating efficiency and the price cap.

It may also be noted that the permanent-rate-base feature, noted above for the service mechanism, applies also to the efficiency mechanism. If the TFP-linked efficiency mechanism had been in effect for FY 2017, and additional authority had been achieved, additional authority would be available on January 1, 2019, to be used for a rate increase to be effective in January 2020, assuming the present schedule. Then mailers would be paying from 2020 onward forever for an indication of efficiency during five years ending in 2017, which should have increased profit. In short, the efficiency mechanism is nowhere near ready for implementation.

**IV. THE COMMISSION SHOULD EXPLAIN HOW IT WOULD ADDRESS THE IMPACT OF FUTURE CHANGES IN THE LAWS GOVERNING THE POSTAL SERVICE THAT COULD OCCUR SHOULD CONGRESS ENACT POSTAL LEGISLATION BEING CONSIDERED IN THE U.S. SENATE AND U.S. HOUSE OF REPRESENTATIVES.**

Looming over this proceeding is the possibility that Congress may enact legislation that alters Postal Service finances in important ways. Congress has been considering changes for several years. In the current Congress, the House of Representatives Committee on Oversight and Government Reform ordered reported a bill on March 16, 2017 (H.R. 756). According to the Congressional Budget Office

(“CBO”) “enacting H.R. 756 would reduce net USPS spending by \$6.2 billion over the 2018-2027 period.”<sup>30</sup> According to CBO the bill would:

- Permit the Postal Service to raise rates on certain mail categories (direct spending savings of \$8.6 billion);
- Authorize the Postal Service to phase out delivery of mail directly to business customers’ doors (direct spending savings of \$2.0 billion);
- Establish a new health benefits program for Postal Service employees, annuitants, and their dependents (net direct spending costs of \$4.5 billion and discretionary savings of \$1.9 billion); and
- Require the use of demographic data specific to Postal Service employees for the calculation of certain retirement benefits, (net direct spending costs of \$0.1 billion, and discretionary costs of \$1.5 billion).<sup>31</sup>

While the fate of this legislation is uncertain, we urge the Commission to inform parties to this proceeding whether and how it would take notice of any legislation and how it would reconcile the effects of that legislation with the actions the Commission may take in this or future dockets.

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<sup>30</sup> Congressional Budget Office Cost Estimate, *H.R. 756, Postal Service Reform Act of 2017*, June 1, 2017, at 3.

<sup>31</sup> *Id.* at 1.

## CONCLUSION

AMCA and PSA support the Commission's proposal to retain principal aspects of the existing price cap system, albeit at current levels, and strongly oppose the proposed Marketing Mail Surcharges. The difficulties with the Commission's Performance Incentive Mechanism are far too great for it to be implemented, and we do not see an easy way to fix it. Finally, the Commission should address now how it will accommodate changes in existing law should they occur.

Respectfully submitted,

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